ACTUAL ESG

Partner Stuart Dunbar visits a vertical farm to explore how our thinking about environmental, social and governance factors helps us back great growth companies to tackle big problems

Stuart Dunbar: Everybody is talking about ESG at the moment. The danger is, it's being reduced to easily measurable metrics. What we mean by Actual ESG is how do we think about the investments we're making for clients and the impact they have in the real world? The reason we're here today, in this vertical farm, is these are the sort of technologies that are of huge interest, as we don't just read about this stuff sitting at our desks, we fund research, we get involved with organisations, such as the James Hutton Institute, where we are today, and the company affiliated with that, IGS.

There's no silver bullet, but places like this vertical farm, think about what's possible here. It's an entirely new way of thinking about an ecosystem. If I wasn't here, I could be sitting at an electric vehicle manufacturing place, we could be in a solar farm, there's any number of places. What we're trying to do is work with and fully understand the disruptions that are coming down the line, as we all have to get to grips with investing and living in a more environmentally, more socially aware world.

I think ESG has become almost uncoupled, in some ways, from an investment discussion. That's absolutely not what we're talking about here. This is not some effort to impose a moral or ethical imperative onto our clients. This is absolutely central to finding what we think will be the great growth companies of the next 20 years. Fundamentally, this is about things that move the dial. There's a huge industry now growing around things like plant-based protein, for example.

So, one of the other things, if we weren't here, we could be somewhere where they're making plant-based burgers. There's a couple of big companies there, Beyond Meat is one of them. We invested in that. And in my view, that's a really interesting example of Actual ESG. But the companies that make plant-based burgers are trying to create something, a product, that's as good as, as cheap as, better for you than traditional ways of creating meat, but is much less damaging to the environment. And people are not voting to save the world, they're buying a product because it's better, and that's how progress really happens.

Everything that you do to try and reduce emissions or to create more social equality is going to have an impact on something else fundamentally. Think of it like a human body. If you rip a human body to bits, and it's all just bits, it's not much use to anyone. If you put it together, you've got this amazing machine that's capable of wonderful things. So, too, we have to think about how we're now investing in a world where the ecosystem matters.

The challenge, and let me give you an example, climate change is a luxury for some people. If you triple the price of petrol, and people can no longer afford to drive their cars, they can't get to work. How is that fair? So, this is systems thinking. You have to try and focus on where you can make a big difference, but in ways that people are willing to embrace and that doesn't completely upset the way that we're used to living.

So, thinking about big wins really matters. And the most obvious example of that would be how the auto industry has changed in the last ten years. If you think about the impact of Tesla, it's not actually or arguably, even mainly that they've displaced a bit of internal combustion engine car sales. It's that they have dragged an entire industry probably five years or more forward from where they otherwise would have been. So, if you're looking for big wins, there's a big win. We are much more rapidly going to get to a world where internal combustion engine cars are no longer sold.

And I think one of the challenges that we, as an investment industry, have is we're obsessed with measuring what can be measured. The really difficult bit is trying to assess the stuff that can't be measured. The future avoided carbon emissions. The value of entrepreneurialism and ambition. So, a lot of what we do is engage with companies. We come to places like this. We try and understand what's happening in the real world as opposed to let's just look up a report in accounts and see how many boxes they tick.

Quite rightly, our clients are super concerned about, my primary job here is to generate the investment returns to allow me to pay the liabilities of my pension scheme, so you shouldn't compromise that in any way. I absolutely subscribe to that view. We're not compromising it by trying to find the great growth companies that are going to be central to this reengineering of the global economy. One of the great difficulties of this is the fact that different clients have different obligations and different views of the best way to invest responsibly.

I don't think it serves anyone to try and insist that this is the way you must do it. I think that's more than likely going to alienate people and make the problem worse. So, we do have a variety. My own view, for what it's worth, is that exclusions from portfolios, for instance, don't own any fossil fuel companies. I can see the logic of that, but it's overly simplistic. But if clients need us to do that because the members of their pension scheme are insistent that that's how they want to behave, then that's okay. Let's not get into some academic debate about it. Let's just do it. We're all trying to move in the right direction.

So, we do offer strategies that exclude thermal, coal, and tobacco. We offer other strategies, which are slightly more nuanced in that they have a carbon intensity target versus a benchmark, for instance. And then for some clients, who are at that point in their journey, they understand, we don't really need to exclude anything. I think it's really important that we try and take our clients with us on this journey, so this is about trying to understand that's most important to different client segments, and trying to work with people to get to good outcomes, rather than jump to the answer, which is maybe too much for a lot of people right away.

Remember that although much of what we're thinking about where we are today is about finding solutions to do things better in the future. One of the big ways we can really tackle climate change in particular is to work with the companies that are what we might call carbon transition enablers. So, for example, concrete is an incredibly environmentally unfriendly thing. But we're going to need an awful lot of concrete in emerging markets to improve their infrastructure, in order to get to a point where they can afford to start to think about climate change.

So, maybe one of the most important things we can do, and we are, in fact, a company like CRH in Ireland, we invest with them and we encourage them to invest very heavily in how can we create something that behaves like concrete, but is far less environmentally damaging in its creation. It's about transitioning to a low-carbon economy. It's not about turning everything on its head overnight. It's just not practical to do that.

Something that's very worth talking more about is this process of engagement that we need to have with the companies that we invest in. We actually have quite a big team internally, what was the governance and sustainability team, we're going to relabel it the ESG team, because that's the terminology now. But much more importantly, both embedding ESG discussions into investment team discussions on how we talk to companies, and also, creating centres of excellence internally that allow us to do that.

We have got, and continue to get, better at understanding things like data ethics, obviously, climate change, technicalities of governance, and human rights. Those are the four that jump out right now, and we've crated internal groups, covering all four of those topic areas, drawing on our investment teams or, in a couple of cases, with dedicated experts, leading on those, we can ensure that our entire investment team understand the issues that arise. Now, with that in the background, that then equips us to go and talk to the management of companies in a very constructive and positive way about how are you thinking about these things?

Again, not because we're on a crusade, but because these are things that in the long run, within our investment horizon, could damage your company. Engagement is also about invest in your future, and that's a five or ten year thing. What's the point in talking to a company about are you on track this quarter? We much prefer to talk to management about what are the opportunities you have? How do you measure progress? And actually, how can we encourage you to do that?

To be clear, we do buy third party ESG scoring data. They're an input to our process. It helps guide us towards issues that maybe we want to think about. Do they have adequate labour relations policies? Do they have adequate wastewater policies. Diversity on a board. Some of the very broad-brush stuff, like United Nations Global Compact Principles, for instance, is a very rough roadmap for responsible investing.

It's helpful if someone comes to us and says well, we don't think they're consistent with that principle. It allows us to go and look at it. More often than not, we'll probably have a different view from the companies we invest in, because we will have thought about it. If you have a passive approach, it will be based on some sort of ESG scoring mechanism, which is quantitative. There's a bit of an abdication of responsibility, in my view.

The third party ratings provider will produce data for an index provider. It might even be the same people. The index provider gives it to an ETF provider. The ETF provider launches a passive fund, which reflects all this quantitative approach, which arguably, completely misses the huge thing, which is what is the purpose of each of the individual companies you're investing in? And it's a problem, because if people think they've addressed a problem, they stop thinking about it. So, arguably, an ineffectual approach to addressing the world's long-term challenges is actually worse than doing nothing at all.

Let's sum up the key things about actual ESG. Remember, this is just an extension of actual investing. Actual ESG is meaningful engagement with companies, to understand how they are evolving into this changing investment environment and meaningfully tackling the E and the S. It's about, in some cases, primary provision of capital to smaller companies that may not be listed yet, to enable them to try and uncover technologies. It's about system-wide thinking, realising that everything has consequences for everything else.

And then there's also the question of what we can do, as engaged shareholders, to impact the behaviour of the companies in which we invest. And because we have a five year, even ten year, investment horizon, the way that we encourage companies to act can be very different to the way that other investors encourage them to act. And I think that's where we really can make a significant difference to tackling some of these really big problems.

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